CASE 6:
The Strategic Economic Rise of China: Global Capital Market Effects

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The case preparers would also like to acknowledge the helpful comments from Paul Sheard, Dexter Senft, and Jack Malvey.
INTRODUCTION: TEN YEARS ON—2012

We should be bolder than before in conducting reform and opening to the outside and have the courage to experiment.  

Deng Xiaoping (1992)

Lehman Brothers’ first study of China was published in 2002 as the “third generation” of Chinese leaders prepared to step down.¹ Ten years on—and twenty years after Deng Xiaoping’s watershed call for bolder reform—we review China’s progress and consider the challenges the now-incoming fifth generation faces in this latest Lehman study.

Looking back, we judge that our “cautious optimism” of 2002 was broadly justified. Despite setbacks, China exceeded the ambitious target of doubling its 2000 GDP by 2010.² In some cases, the setbacks—notably, the 2004 stock market crisis—were exploited by the authorities to accelerate the economic reform programmes underpinning this remarkable growth. Nevertheless, the “present realities” confronting the fifth generation leaders when they take over in March 2013 remain daunting. Average annual income per capita is just $2,500, and income inequality has widened—although, thanks to the development of the social safety net, only a handful of China’s 1.45 billion population now lives below the UN poverty line (i.e., $5 per day).³ But that social safety net and, arguably, relative social stability have only come at the expense of a massive expansion in public debt to almost 100% of GDP, with all that implies for future fiscal policy. This occurs in the context of slowing growth—we look for average growth of 5.5% per annum between now and 2020, compared with 7.0% from 2001 to 2010.

More significant still, the next ten years will see growing popular pressure for political reform—a challenge acknowledged by China’s leaders but, as yet, without any clear idea emerging of how the authorities will respond in practice. On top of domestic political challenges, China’s leaders will also be tested by a whole raft of international economic and political issues that, if mishandled, could have serious consequences. Most notable


² At $3,500 billion, China’s GDP in 2011 was equivalent to $2,300 billion at 2000 prices.

³ For comparison, in 2002, average income per capita was equivalent to $1,400 per annum at today’s prices. Best estimates are that in 2002, around 50 million Chinese lived below the then UN poverty line of $2 per day.
is Taiwan—still the greatest underlying source of friction between Beijing and Washington despite the latter's support for Japan's re-militarisation.

Especially given the economic record of the past twenty years, if the economy could be considered in isolation, we would be optimistic about China's prospects almost without qualification, despite the challenges that remain. However, perhaps the most significant difference between the past and the forthcoming ten-year period is that political reform cannot no longer be left on “hold” in favour of economic growth. First, the political status quo is increasingly no longer an option in pure governance terms. And second, China is approaching the stage in its economic evolution at which growth prospects could be significantly handicapped were there not to be substantial political reform—which would, in turn, likely lead to an upsurge in political discontent and consequent instability.

Thus, the most daunting “present reality” facing the fifth-generation leaders is the need to steer China on a course of political evolution that will match the aspirations of ordinary Chinese while, at the same time, preserving political stability and economic well being. Their task could be complicated further by geopolitical factors. At this stage, therefore, we find it impossible to put the chances that China will continue to enjoy a relatively smooth transition towards becoming a fully functioning democratic free market economy for the duration of the next decade at better than 50:50.

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1 May 2012
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1. The Economy: Evolution and Equilibrium

Our greatest glory is not in never falling, but in rising every time we fall.

Confucius (551-479 BC)

From a Daunting Challenge . . .

In January 2002, just five weeks after China joined the World Trade Organisation (WTO), we identified a number of major economic challenges with which the then-incoming fourth-generation leadership would have to grapple.4 In the fourteen months that followed before the fourth generation finally took over in March 2003, those challenges were made all the more daunting by three factors.

The global slowdown: China rode out the global economic slowdown of 2001/2002, but did so only by relaxing both monetary and fiscal policy in order to boost domestic activity and compensate—in 2H01 especially—for weak export markets. In the prevailing slightly deflationary environment, the former had little if any negative impact. But the latter inevitably pumped up the (largely domestic) public debt/GDP ratio, which was already trending towards potential problems downstream. Even then, the fiscal easing that Premier Zhou Rongji oversaw in 2002 was not sufficient to prevent widespread—and often coordinated—demonstrations by workers and former workers in state-owned enterprises (SOEs) as reform-driven redundancies continued to mount against the backdrop of a totally inadequate social safety net.

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The impact of WTO accession: WTO accession locked China into a large number of painful structural reforms within legally binding time frames. While we judge that China’s leaders had calculated as carefully as possible the impact of these reforms, it is equally clear that the full implications of some of them—perhaps especially for the already stressed agricultural sector—only really became fully apparent in the post-accession period as the technocrats in the relevant ministries in Beijing were able to assess comprehensively the 1,000-odd pages of China’s accession agreement.

The domestic political cycle: China may not enjoy universal suffrage and an electoral cycle as such, but its leaders are still susceptible to the political cycle. The first nine months of 2002 were marked by behind-the-scenes maneuvering in the ranks of the Chinese
Communist Party (CCP), as the more reformist members of the third-generation leadership sought to protect their inheritance by ensuring—ultimately successfully—that reformers continued to dominate the Politburo when the fourth generation took over. The most notable consequence of this was that a lame duck administration effectively put new structural reform on “hold” for the better part of 15 months—and it was, inevitably, some months after the fourth generation had taken over that China’s new leaders were able to kick-start reform again. In the interim, pressing issues became urgent.

...Along the Rocky Road of Reform...

Despite the speed with which exports rebounded in 2002/2003 and the continuing growth of FDI inflows (worth $65 billion in 2003), from the outset, the fourth generation was well seized of the need to address reform issues urgently. But they were just as aware that the inter-related nature of the challenges with which they had to grapple meant that they had to get the sequencing of reform right if they were to avoid the sort of crises that had beset other Asian economies in the late 1990s. And they knew that there was no “textbook” solution.

In retrospect (and as some commentators—including in China itself—warned before the event), the March 2004 stock market crisis confirms that Hu Jintao and his fellow fourth-generation leaders erred on the side of being too cautious in the pace at which they initially advanced reform. However, we stand by the conclusion that we reached at the time: that a crisis of some sort was almost inevitable after the lengthy time-out from reform that surrounded the third generation’s handover. And it is much to the credit of the fourth generation—especially then Premier Wen Jiabao—that it not only managed to keep the

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5 Although the past ten years have been marked by strong FDI inflows (to the point where China overtook the U.K. as the world’s second largest recipient of FDI per annum in 2008) that are set to continue, their impact on China’s balance of payments (BOP) is increasingly being offset by outward FDI. We anticipate that as more Chinese brands join the already-swelling ranks of China’s globally recognised manufacturers of an increasingly wide range of consumer goods in particular, FDI outflows will strengthen further. On present trend, inward FDI flows will be overtaken by outward ones in 2025, although the current account (which returned to surplus in 2006 after a period of small annual deficits post-WTO accession) should easily sustain the BOP in positive territory. The likely impact of this on the RMB is considered in footnote 15. The main beneficiaries of Chinese outward FDI to date have been the United States, Germany (China’s closest EU partner), India (in the IT sector in particular), Russia (for primary extraction in the east, where more than 2 million Chinese now live either legally or illegally), and Iran and Indonesia (again, predominantly energy related)—a pattern we expect to continue.

6 Ironically, China’s leaders inadvertently contributed significantly to the crash. From October 2002, when the precise makeup of the fourth-generation leadership became clear, the stock market began to surge. This, combined with reform-related increases in government expenditure, encouraged the government to start divesting its ownership in SOE shares again. This was compounded by a huge number of IPOs as companies tried to raise funds by bypassing banks, which were reluctant to lend because of their deficiencies in credit risk and existing stock of NPLs. The result: massive oversupply and a stock market crash.
The 2004 stock market crash kick-started a renewed surge of economic reform. That said, the leadership's immediate response to the crisis owed more to its fears for its own (and, in all probability, the CCP's) survival than for China's longer-term economic well-being, as literally hundreds of thousands of "mom and pop" investors, who bore the brunt of the losses, took to the streets of nearly all of China's major cities in protest. Only a judicious mix of firm (and occasionally overly firm) policing and a rapidly announced, far-reaching stock market reform package, which halted the slide and started to restore confidence, saved the day. And having dealt with the immediate crisis, Wen Jiabao, in particular, deserves great credit for agreeing to, announcing, and implementing the ambitious longer-term reform programme that followed.

As a result, from late-2004 onwards, progress with the five key economic challenges we had identified in 2002 accelerated significantly, as follows.

Dealing with the adjustment costs to WTO: the third generation's decision to take China into the WTO was primarily a means to an end and not (as sometimes portrayed in the West at the time) an end in itself. The principal objective was to lock China into a reform track down which its leaders were in any case determined to take it, through the binding international obligations inherent in WTO membership. Furthermore, the terms of China's accession set out time frames in which a wide range of key reforms had to be concluded. We judge that China's top decision-makers had calculated as carefully as possible the adjustment costs inherent in the terms of the country's WTO accession well before negotiations were concluded in the second half of 2001. Arguably, these challenges were the most pressing faced by the fourth-generation leadership, not least since their consequences reached through into all sectors of the economy (and therefore significantly affected the other four key economic challenges we identified in our 2002 study).

WTO-related challenges were probably the most pressing facing the leadership in 2003. Growing protectionism elsewhere made the task confronting China's leaders all the harder. Domestic resistance to WTO-driven reform generally mounted in 2002-2003. In part, this was an inevitable response to the wider realisation within China of the extent of the country's accession commitments. But it was also a reflection of increasing global trade frictions, the proximate cause of which was the politically driven imposition by the

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7 Unification of the former Shanghai and Shenzhen stock markets was just one of the reforms that were brought in 2005 following the 2004 crisis.
United States in February 2002 of extensive steel tariffs to protect workers in electorally sensitive states as critical mid-terms loomed. However, the shock of China’s 2004 stock market crisis helped the fourth-generation leaders argue down repeated calls for similar protection for China’s workers threatened by swelling foreign competition. Even so, the pattern set by Zhu Rongji in 2002 of using fiscal policy to soften the socio-economic impact of reform—and, therefore, minimise the associated risk to political stability—was continued by the fourth generation and has only really begun to be ratcheted back in the past four years.

The agricultural sector was the hardest hit by China’s WTO accession. The cost of adjustment to China’s WTO accession has had to be met in more or less all sectors of the economy. But even taking into account the impact of jobs in the SOEs—the reform of which was only around 50% complete in December 2001 (see below)—the greatest impact of all was almost certainly on the highly protected agricultural sector, which, at the time of accession, employed around two-thirds of the 450 million rural workforce (estimated by the World Bank to amount to around 48% of total employment in 2001).

Addressing agricultural reform was further complicated by the CCP’s strong rural roots. Even in 2001, the majority of its 65 million or so members lived in essentially rural regions, and most of these were either directly or indirectly dependent on farming for income. The agricultural sector was the hardest hit by China’s WTO accession.

8 Most experts agree that in bringing in these measures, the fundamentally pro-free-trade Bush administration was not simply motivated by electoral concerns (which were, in any case, likely to be resolved to the satisfaction of Republicans by electoral boundary changes introduced in early 2002—see, e.g., “Congressional Redistricting: How to Rig an Election”, The Economist, 27 April 2002, pp47-8). Almost certainly more important in USTR Robert Zoellick’s mind was the need to secure congressional support for Trade Promotion Authority (TPA) to provide a major boost to the chances of successfully completing the Doha Round of WTO negotiations launched in November 2001. In the event, the administration narrowly failed to win the vote in the lower house in December 2002, against a backdrop of increasing global trade tensions and domestic economic concerns rooted in the 2001 slowdown (for more background see “Anatomy of a Rotten Deal”, The Economist, 18 May 2002 pp55/6). In retrospect (and as many feared at the time), although it was far from the sole (or, arguably, even major) cause, this effectively marked the end of any prospect of far-reaching liberalisation emerging from the Doha Round. This, in turn, very nearly brought about the demise of the WTO as developing countries in particular reacted to that failure at the November 2007 Ministerial in Shanghai. However, the Chinese-brokered Shanghai Agreement pulled the WTO back from the abyss and has since provided an imperfect but nevertheless workable basis for the organisation to pursue further liberalisation by means of ad hoc and sector-specific plurilateral agreements, rather than the previous approach of all-embracing all-party rounds. The agreement—and China’s subsequent leadership in the WTO—may owe much to self-interest (albeit enlightened self-interest), given China’s continuing competitiveness and economic reliance on exports (NB: exports accounted for 40% of China’s GDP in 2010), as well as its developing country leadership aspirations. But it has nevertheless won Beijing well-deserved plaudits from emerging economies in particular, as well as—arguably—encouraging the Chinese broadly to hold to their own WTO obligations. For further background see “Special Report: Trade Disputes—Dangerous Activities”, The Economist, 11 May 2002 pp 91-93.
their livelihood. It is, therefore, unsurprising that the most significant blots on China’s generally creditable performance relative to both the letter and the spirit of its WTO accession obligations were to be found in the agricultural sector.

China followed the example of many of its peers in the WTO by bending the rules on agricultural protectionism. The most contentious of these were non-tariff barriers to imported foodstuffs (NB: the protracted row with the U.S. and others over GMOs that remains tied up to this day in grinding WTO negotiations on food safety). But more damaging in terms of China’s fiscal position was the marked increase in subsidies—both legitimate and hidden—to China’s farmers to cushion them against more competitive foreign imports. To be fair, these never even approached the sort of levels seen for much of the past decade in either the EU or the U.S. (which may indirectly have encouraged China’s leaders to boost subsidies by a massive increase in its own financial aid to farmers in 2002); and the past five years have seen some significant ratcheting back as the sector as a whole has become more efficient thanks to improved farming techniques and a massive (and continuing) reduction in the agricultural labour force to around 230 million. But the consensus

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9 That said, even in 2001, outward migration from the rural interior was already beginning to shift the weight of party support. And this process was accelerated when, despite considerable opposition from conservatives, the then President Jiang Zemin (in what was effectively his final major reform) was able to open up the party officially to private businessmen at the 16th party congress in September 2002, consistent with the principles set out in his “Three Representatives” theory first postulated in early 2000. Officially admitted to the party’s ranks, China’s then 1.5 million business owners (of which about 20% were in fact CCP members in any case) were much more willing to support party membership among their employees (consistent with Jiang Zemin’s objective of maintaining CCP influence in every strand of Chinese society). In consequence, although CCP membership in toto has remained more or less static for the past decade, around 60% of members are now to be found in private sector enterprises in the richer eastern and southern regions. This has resulted in a much less conservative and more enterprise-oriented core to the party, which, for the past five years or so, has underpinned the leadership’s determination to push through economic reform. But the extent to which the party’s modernising core favours political reform remains a matter of speculation.

10 If there is one sector in which China may have underestimated the impact of its WTO accession terms, it is agriculture. It rapidly became clear after China had joined the WTO that—as many commentators had suspected—MOFTEC had kept other technical and microeconomic ministries at best only partly informed about details of the accession negotiations relevant to their respective portfolios. While this undoubtedly helped China to agree terms with WTO partners, it also almost certainly meant that its negotiators agreed to concessions without in all cases fully grasping their implications for China’s socio-economic fabric. Nevertheless, there is no reason to conclude that the outcome of the negotiations was anything other than totally consistent with the objectives of China’s top leaders and, therefore, the remit that MOFTEC had been given.

11 According to the World Bank, the reduction in the agricultural labour force of 70 million over the past decade amounts to about half the labour shedding that the reform of the sector is likely to generate by 2020, with agricultural employment expected to account for no more than 25% of total employment by the end of the present decade.
among experts is that WTO membership-rooted agricultural subsidies alone have added 10-15 percentage points to China’s soaring public debt/GDP ratio.

More broadly, adjustment costs across the board encouraged China’s authorities to maintain the sort of loose monetary and fiscal policies adopted in 2001. In the case of the former, interest rate deregulation and steps to develop a deeper corporate bond market in 2006 did not immediately free the People’s Bank of China (PBOC) from political “interference”. But the PBOC was given an increasingly free hand in practice in response to the recession in the U.S. (and associated global slowdown) that followed the devastating attack on Seattle by al-Qa’ida in 2007, which was deepened by the lengthy oil price “spike” induced by the sudden collapse of the regime in Saudi Arabia in 2008 (when China’s leaders again did well to resist rising domestic protectionist pressures).\(^{12}\) We judge that since then, the PBOC has proved itself to be a competent manager of monetary policy.

As for fiscal policy— as the current (and still rising) 100% debt-to-GDP ratio indicates— this has remained too loose for too long, presenting the fifth generation with what may well prove to be its biggest single economic challenge—and one with significant potential political implications, which we explore in Chapter 2.

Agriculture apart, if there is one area in which China is open to criticism relative to its WTO obligations, it is intellectual property rights (IPRs). A powerful combination of vested interest, corruption, and the weaknesses inherent in China’s legal system (see Chapter 2) have mitigated against sufficiently robust action to protect IPRs—even where domestic firms and foreign firms incorporated in China are having their rights infringed and despite repeated resort by various governments to WTO dispute settlement. Admittedly, the record of IPR enforcement is much better in some regions than in others. But the fifth-generation leadership must look urgently to address both the specific malady and the factors that underpin it if this is not to discourage FDI and prove a drag on economic growth in the future.

Financial sector reform: although banking reform was still not as rapid as some had hoped when China first joined the WTO, in the event, the Chinese authorities did stand by the letter of their obligations, and the period 2004-2007 saw massive liberalisation...
(including opening the sector to foreign banks and interest rate deregulation in 2006) and consequent vast improvements in the efficiency of the sector as a whole. Apart from the broad benefits that this brought to the economy, it also largely dealt with the specific problem of the continuing expansion of non-performing loans (NPLs), which by 2005, officially amounted to around 45% of total loans. Thereafter (and no doubt further encouraged by the long-anticipated banking crash in Japan in June 2007), the authorities grasped the nettle of bank recapitalisation, and the Asset Management Companies (AMCs) were spurred to greater efforts in disposing of bad loans. These efforts notwithstanding, the fifth generation still looks set to inherit a legacy of outstanding NPLs equivalent to around 20% of GDP.

The CSRC and the CIRC have provided competent financial sector oversight

The fourth generation was fortunate to inherit an extremely competent oversight body in the form of the China Securities Regulatory Commission (CSRC). The CSRC suffered something of a setback in early 2002, when its recommendation, made in the wake of the Bank of China scandal, to have bank audits by foreign firms made mandatory was watered down somewhat. But by and large, it has consistently enjoyed the full backing of China’s leaders— as, indeed, has its counterpart in the insurance sector, the CIRC, which has been a key determinant in the healthy reform and growth of non-bank financial institutions.

The stock market has driven improvements in corporate governance

Another important positive influence—the impact of which has been much broader than just the financial sector—has been successive reforms to corporate governance regulation. This has been driven in significant part by both the stock market—with, since late-2003, the help of the ever-growing number of Qualified Foreign Institutional Investors (QFIs)—and the AMCs. For sure, this is one of a number of areas in which we look to the fifth generation to bring in further improvements—not least in enforcement, where the overarching principle of ren zhi (the rule of man) ensures that the legal base remains suspect (considered further in Chapter 2). But China can now legitimately claim to have a regulatory framework for corporate governance that compares favorably with OECD standards.

Liberalisation of the capital account has been slower than hoped

Parallel steps on exchange rate policy also began in earnest—albeit at a stately pace—in 2004, with the RMB/USD exchange rate allowed to fluctuate within a narrow trading band of ±3% from 1 December (again, later than we and other commentators had hoped).

13 In lobbying against joint ventures with foreign firms and, recently, a drift back by many Chinese firms to (reputable) domestic auditors.
Unsurprisingly, given continuing healthy FDI inflows and a current account that had returned more or less into balance after small deficits in each of the three preceding years, the RMB moved immediately to the upper end of its new range (i.e., RMB8 = $1) where it remained.

Given the very real progress with reform that took place between 2004 and the 17th party congress in September 2007, it was something of a disappointment to many commentators when the then-new government announced in the budget debate at the March 2008 National People’s Congress (NPC) that full liberalisation of the capital account would not take place before 2013 at the earliest. 14 But we judge that had China responded positively to calls to liberalise the capital account from 2009, the risk of a currency crisis would still have been considerable. That said, the surprise announcement at the end of 2008 of a managed float against a trade-weighted basket of currencies with effect from 1 January 2009 (which saw an immediate further 10% RMB appreciation to RMB7.2 = $1) was a timely move. Ideally, we would have liked to have seen the final step of capital account liberalisation taken by now. But we acknowledge that the political cycle mitigates against such a move at this time and look for an early and decisive move by the fifth-generation leadership after March 2013.15

Restructuring of SOEs: it is to the credit of the third-generation leadership that even in its last days, the impressive pace of SOE restructuring never slackened. For example, in 2003, more than half a million jobs were shed in the north-east “rustbelt” province of Liaoning alone, despite extensive and well-organised worker resistance there. However, it was not until banking sector reform started to bite in 2006 and the flow of politically driven loans to non-creditworthy enterprises finally started to dry up that the pace of SOE reform took a quantum leap forward—further accelerated by the belated enforcement of the 2004 bankruptcy laws.

14 We do not accept the argument that capital account liberalisation would have come about by now had Wen Jiabao, an ally of Jiang Zemin, not stepped down from the premiership after the 17th party congress in favour of Bo Xilai, who, like Hu Jintao, is a protege of Deng Xiaoping. If anything, Bo Xilai is even more reform minded than his predecessor. But he and his politburo colleagues will have weighed the benefits of capital account liberalisation carefully against the desirability of strengthening further the financial sector as a whole before taking that step.

15 Assuming a smooth handover of power to the fifth generation—which we judge to be a probability notwithstanding the manoeuvering for position now going on behind the scenes (see Chapter 2)—and a fairly rapid decision (say, by the end of 2013 by the latest) to liberalise fully the capital account and move to a free-floating currency thereafter; for reasons touched on in footnote 5, we expect the RMB to appreciate further—probably stabilising around 10% above its current value in the medium term, i.e., at about RMB6.5 = $1. Once the new arrangement has settled down, we anticipate a move—perhaps in 2015—to re-peg the HK$ to the RMB rather than the US$.
The process of dismantling the SOEs is now all but complete. Given the close linkages between the corporate and financial sectors, the success in SOE restructuring is a major relief for the financial sector by reducing the occurrence of new NPLs. The pessimists argue that—thanks to the lag between shedding jobs in the state sector and the creation of new jobs in the private sector—this has been achieved only at considerable cost in terms of the welfare budget with major (negative) consequences for fiscal policy throughout the next decade (see below).16 But that money would have had to be found anyway, even if it had been in the form of continued non-recoverable loans to non-viable SOEs. And most important for China’s future economic well being, the overwhelming burden of the SOEs to China’s economic development as a whole has finally been eradicated.

The development of a social safety net: In early 2002, the authorities were trailing in the race to develop a social safety net commensurate with the need to minimise the socio-economic impact of SOE restructuring and, therefore, the risk of associated political instability. Post-2002, their task was made worse by agricultural reform. As noted above, although agricultural subsidies were significant, they were (by design) insufficient to prevent extensive lay-offs. Thus, agricultural workers added significantly to the numbers of unemployed both in rural areas—as the town and village enterprise (TVE) sector failed to expand sufficiently quickly to soak up excess labour until after banking reform was well-advanced and credit more readily available—and in the major cities as displaced workers migrated in search of new employment. This, in turn, placed further strain on the state-controlled social safety net, which the fourth generation leadership set about strengthening more or less from the day they took office.17

Since 2006, the cost of China’s social safety net has been 3% of GDP pa

16 Despite vast improvements in the reliability of Chinese statistics in the past decade (see footnote 21), official figures for unemployment are one area in which major question marks remain. According to China’s National Bureau of Statistics (NBS), urban unemployment reached a peak of 9.8% in 2007, compared with official figures of 3.4% in 2001 and 6.5% in 2011. However, most experts agree that the true figure in 2007-2008 was around 12.0% (compared with 13% in 2001 by our estimate) and that it remains above the politically sensitive 10% figure, albeit by probably just 1% or 2%.

17 The fourth-generation leaders stuck with the approach that emerged in the final months of the third generation’s era of coupling, improved social security protection for laid-off workers, and increasingly generous redundancy payments with allowing reform-related strikes and demonstrations to take place (away from Beijing) as a kind of “safety valve” to help defuse socio-political tensions. However, throughout the past decade, these “carrots” have been coupled with the “stick” of rapid crackdowns where demonstrations have looked to be getting out of hand and the rounding up for “re-education” of workers’ leaders who have overstepped the limits within which the politburo has been prepared to let resistance to reform become organised.

For further background, see “Protests but No Bullets”, The Economist, 6 April 2002. This article, to our mind, represents a rare example of balanced reporting of events of this sort in the Western media, which, in general, has all too often written them up as a clear sign of the imminent nationwide chaos and/or the collapse of the regime. China’s domestic media, on the other hand, has seldom reported them at all—see footnote 28.
That task was all but completed by October 2006 with the introduction of a national (if fairly minimal) pension; but only at the annual cost of around 3% of GDP, which persists to this day even though, like pensions, health provisions remain limited and all benefits barring primary and secondary education are effectively means tested, thereby obliging the urban well-to-do to turn to the private sector. On the plus side, this has encouraged China’s authorities to allow the role of QFIs to grow and has created an environment in which well-regulated domestic mutual and insurance funds have been able to establish themselves, if not exactly to blossom to their full potential as yet. The next step in bolstering welfare provision must be the liberalisation of the capital account, which—as noted above— the fifth generation should address as a matter of urgency.

Managing urbanisation and overcoming disparities in regional development between the east and the interior: after a slow start, the fourth-generation leadership has picked up the pace in addressing regional disparities. But much remains to be done, especially if a further 80 million or so agricultural workers likely to be displaced over the next ten years are to be found jobs in their “home” regions.

Key to the development of the interior are ambitious—and largely state-financed—infrastructure programmes. The pace of highway construction—the main plank in opening up the interior—which has benefited significantly from loans from the World Bank and the Asian Development Bank (ADB), is set to slow over the next few years. But China remains on target to complete a nationwide grid of 55,000 km (second only in length to that of the United States) linking all the major cities by 2020. The ADB, in particular, continues to help finance the development of feeder roads from minor towns, which it has long seen as vital to its (and the government’s) poverty alleviation goals. Furthermore, the highway programme should be self-financing thanks to the imposition of tolls on road users which—like fuel taxes—are weighted in favour of freight and commercial travel and discourage use of private cars for leisure and commuting.

Two (foreseen) consequences of the highway programme have been the development of urban belts (the first of which emerged along the Beijing-Tianjin expressway opened in 1993) and the emergence of new conurbations at highway interchanges, which have been deliberately sited away from existing major cities in order to encourage urban growth in

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In 2011, 75% of FDI went to the interior, and migrant workers are starting to move back to their home regions. Nevertheless, large pockets of underdevelopment persist in China’s interior and, for all the fact that statistical poverty has been all but eliminated, the Gini coefficient—a common measure of income inequality—rose from (non-official) estimates of around 45 in 2001 (i.e., already around internationally recognised danger levels) to 49.5 in 2011, continuing a trend that dates back to at least 1981 (when the coefficient was a modest 28.8). More worrying still from the perspective of policymakers intent on maintaining political stability, the gap between the richest and poorest urban households has also continued to widen to the point at which the top 20% receive 44% of total urban income and the bottom 20% a meagre 5.7%. Thus, although both urban and rural poor are undoubtedly better off now in absolute terms than they were a decade ago, relative to the well-to-do, the poor have fared badly under the fourth-generation leadership. Furthermore, China’s middle-income urban householders, whose numbers have expanded rapidly throughout the past decade, have also fallen behind relative to the top 20%. As the fifth generation looks to address the fiscal legacy that it will inherit, it is here, perhaps, that the greatest potential political pitfalls lie.

19 A Gini coefficient of one represents perfect equality, while 100 means a single person received all the income.
20 According to The Economist of 2 June 2001, the comparable figures at that time were, respectively, 40% and 6.5%.
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To a Pretty Impressive Inheritance

In sum, relative to the five key economic challenges that we identified in 2002, our “end-of-term” assessment of the performance of China’s fourth generation leaders is as follows.

**WTO adjustment**: impressive progress, with WTO-related reform in all sectors barring agriculture, which has lagged thanks to a slow start. IPRs remain a serious problem. More broadly, China has emerged as a major driver towards further liberalisation of global trade. **B+**

**Financial sector reform**: after a slow start, there has been steady—but not spectacular—progress since the 2004 crisis. Despite a residue of NPLs still to be disposed of, the banking sector is generally in good shape, as are non-bank financial institutions. Full liberalisation of the capital account and the stock market and the free floating of the RMB are now overdue. And there is more to be done still on corporate governance. **B+**

**Restructuring of SOEs**: pursued and concluded with impressive determination despite the (more or less inevitable) failure of the private sector to generate new jobs at a comparable pace. But the result is a worrying fiscal legacy with which the fifth generation will have to grapple as a matter of urgency. **A-**

**Social safety net**: essentially political imperatives have seen the rapid development of an adequate if fairly minimal social safety net that has kept pace with SOE and agricultural reform. Nevertheless, this has come at considerable cost, around 3% of GDP per annum, and the fifth generation will increasingly be confronted with the question of the extent to which it is affordable as the problem of an aging population begins to register increasingly towards the 2020s. **A-**

**Socio-economic inequalities**: lifting all but a handful of Chinese out of statistical poverty and improving standards of living across the board have been impressive achievements, and significant progress has been made in boosting the economy of parts of the interior. But income disparities haven’t widened, and many regions remain sorely underdeveloped. **B+**

As our assessment of these five key challenges suggests, the weakest strand to the fourth generation’s economic management has been fiscal policy, which—in part, at least, to offset some of the stresses that addressing these challenges has induced—has, in our judgement, been too loose for too long. The result is a 100% public debt-to-GDP ratio that will have to be addressed against a background of growth rates that are likely to be...
The economic platform from which to launch political reform is as good as could have been expected.

Overall, we judge that—despite the economic challenges that will now remain on the table when the fifth generation takes over, some of which will need to be addressed urgently—the fourth generation is leaving behind a reasonably impressive economic legacy. The outstanding economic issues notwithstanding, this offers at least as good a platform as the fifth generation might have expected to inherit for the even more daunting challenges of political reform that lie ahead.

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21 It is widely accepted that there have been real improvements in Chinese statistics over the past decade (including those in the 2010 census) and that all but unemployment data (see footnote 16) are now broadly reliable. But question marks remain over figures for growth in the latter years of the last century and the first years of this. Our view has always been slightly more relaxed vis-à-vis the latter period at least. For reasons set out in China: Gigantic Possibilities, Present Realities (p17), we judge that the upward bias in China’s official GDP growth rate was no more than 0.5 to 1.0 percentage points by 2000. Furthermore, we accept the argument put forward at that time by, among others, Professor Shen Ming Ming of the Research Centre for Contemporary China at Peking University that unreported economic activity (notably associated with tax evasion, which, thanks in large part to corruption, remains a problem to this day) may have compensated for the upward bias in official statistics.
2. POLITICAL REFORM: THE GOOD OF MAN VERSUS THE RULE OF MAN?

The good of man must be the objective of the science of politics.

Aristotle (384-322 BC)

Confucianism remains the dominant philosophy of the Chinese state.

The teachings of Confucius (551-479 BC) have been the dominant philosophy of the Chinese state even in the period between 1919 (when they were officially discredited as a barrier to modernisation) and 1990 (when he began something of an unofficial comeback). It is this philosophy that underpins the overarching principle of Chinese law: that the state has primacy over the rights of the individual. And that principle (rather than communism) is what lies at the core of the gulf that exists between the contemporary Chinese political model and Western ideas of governance and democracy, which owe much to the teachings of the Greek philosopher Aristotle, who was born almost a century after Confucius died.

Confucianism may no longer be consistent with the political aspirations of the Chinese people.

What is less clear is whether the same gulf exists between the growing political aspirations of ordinary Chinese, especially the swelling urban middle classes, and the political reform intentions of China’s fifth-generation leaders. The challenge facing the fifth generation is not whether it can engineer political reform, which will satisfy China’s critics in the West—it could not do this either by accident or (even less likely) by design and hope to remain in power. Rather, the real question is whether, during the next decade, China’s leaders will be able to promote a peaceful process of political evolution that will keep pace with the likely ever more ambitious aspirations of the Chinese people. The answer may lie in the extent to which China’s politicians and China’s people may or may not differ over what constitutes the Aristotelian concept of “the good of man” and how best that end may be met.

The line-up of the fifth generation politburo remains unclear.

With five months to go before the 18th party congress, when the line-up of the fifth-generation leadership due to take power in March 2013 will effectively be decided, it is still not clear who will occupy either the top three jobs or the remaining four seats around the politburo table. As deeply untransparent manoeuvring continues behind the scenes, any one of four, or even five, presidential candidates could succeed Hu Jintao (whom we expect for now to hang on to the chair of the powerful Central Military Commission in any case).22 And there are at least a further seven credible candidates for politburo seats.

22 One possible candidate to wrest the chair of the commission away from Hu Jintao is politburo member Pan Yue, who has strong connections with the army—not least through his father-in-law, a former chief of staff.
Furthermore, it is conceivable that different individuals will emerge as party secretary and as president, especially as the latter post transforms slowly into an honorific position. If that were to happen, it would be the final nail in the coffin of the concept of “supreme leader” as personified by Mao Zedong and Deng Xiaoping.

The trend towards the diminution of the power of the president and greater collective governance and responsibility has been reinforced by the Hainan Telecommunications scandal in 2010, which brought down a number of the Hu Jintao’s close associates. And—competent though Hu Jintao has been, including in balancing interests at the top of the party—it is likely that the power of the chair of the Central Military Commission will abate somewhat as the new politburo looks to assert itself as the dominant political entity in China. But make no mistake: the People’s Liberation Army (PLA) will remain hugely influential as the “bottom line” guarantor of the CCP’s grip on power.

In part, the ongoing power struggles reflect the strength in depth of China’s emerging generation of leaders. Essentially “home-grown” talent such as Pan Yue, who was first appointed vice minister more than a decade ago, when he was still in his thirties, and who has been a member of the politburo since 2007, has been boosted by returnees from abroad such as Fang Xinhui, Gao Xiqing, and Xia Ying, who were parachuted straight into vice ministerial posts over the heads of long-term career officials around the start of the century and who have since advanced on merit. But they are also a measure of the prevailing polarisation at the top of the party hierarchy. For although the “Shanghai Gang” lost considerable influence in the immediate aftermath of Hu Jintao’s wresting of Jiang Zemin from the chair of the Central Military Commission in 2007 (forcing the

23 For some of the insights in this section, we are indebted to a confidential internal paper “Key Technology Policy Trends and Policy Influencers in the PRC: A White Paper” by Claydon Gescher Associates, December 2001.

24 Although Hainan Telecommunications was just the latest in a notable line of corruption-related scandals that have been exposed in public dating back to the Bank of China affair in 2002, it was particularly notable as the first (and, to date, only) one that resulted in successful legal action (as opposed to party internal disciplinary measures) being taken against top CCP members.

25 The emergence of returnees in the highest levels of government has been further encouragement—if any were needed—for Chinese to seek education and initial employment overseas. While it would be going too far to say that this has been a deliberate policy move by the authorities as part of their broad drive to enhance China’s human capital, it is certainly the case that experience outside China is now seen as a clear advantage in both the public and the private sector. Precise figures for Chinese working overseas are hard to come by, as are figures for returnees, although surveys of Chinese working in the West have consistently indicated that well over 80% intend to return to China no later than mid-career. But data for Chinese in secondary and tertiary education overseas are available and continue to show a steady increase in numbers year-on-year. The main beneficiary remains the U.K., which since 2006 has consistently hosted over 100,000 Chinese in full-time education at any time (worth around $5 billion a year in invisible earnings), followed by Canada, Australia, the U.S., and New Zealand.
former president into official retirement), its members have made something of a comeback since the Hainan Telecommunications scandal.

What we are sure about is that whoever occupies the seven seats around the table, the new politburo will be even more technologically and scientifically minded than the current one; it will be well equipped in the professional and institutional crafting of policy; it will have been more exposed first-hand to Western models of governance; and it will recognise the necessity of political reform even if it is determined to bring that about in a way that ensures the continuation in power of the CCP. The same can be said of those who will take up the various ministerial portfolios, whom we expect to ensure that key positions in their respective domains are occupied by competent technocrats as the last of the old generation bureaucrats are nudged into retirement.

The Law of the Land

Some commentators have tended to dismiss the significance of what happened in the immediate aftermath of the Hainan Telecommunications scandal on the grounds that it marked not so much a fundamental shift in the workings of the Chinese legal system as a successful strike by one faction within the party, i.e., close associates of Jiang Zemin, against another, i.e., the supporters of Hu Jintao. And that even then it probably would not have happened at all had not foreign investors been severely stung. Both arguments have some validity. But in our judgement, they rather miss the point. Taking the second argument first, the increasing openness of China’s economy— and its leaders’ continued acknowledgement that that openness is fundamental to China’s economic well being— is forcing real improvements in the way in which China’s legal system operates consistent with the established principle of yi fa zhi guo, “to rule the country according to law”.26 As for the first argument, it should be kept in mind that it was a powerful faction within the CCP that elected to force those involved and implicated in the scandal into the courts rather than leaving it to the party to discipline them. In so doing, a precedent has been set that, irrespective of motivation, offers some encouragement in the longer term.

26 The idea that economic openness drives political reform seems to be as dear to the heart of President Hillary Clinton as she seeks to defend engagement with China against pressure from the increasingly vociferous pro-Taiwan lobby in Congress, as it was to her husband who, during the second term of his presidency in particular, defended the annual renewal by Congress of (pre-WTO membership) MFN status for China on the grounds that trade would significantly help to democratise China. While there is undoubtedly truth in it, it looks to be a far more gradual process than either of the Presidents Clinton would have had us believe and certainly one that offers no guarantee that a Western-style democracy—as opposed to one dominated by “Chinese characteristics”—will eventually emerge.
But it should be underlined that this precedent does not, in our judgement, go against the long-standing principle of ren zhi, the “rule of man”, which still dominates Chinese law despite the emergence of a stronger, more transparent, and increasingly well-defined legal framework beneath that over-arching philosophy. In other words, the CCP’s political primacy remains constitutionally enshrined, effectively placing it—and the PLA—above the legal system. Furthermore, the judicial system is still part of the party-state governance system. What may have changed—certainly if the precedent of the legal action surrounding Hainan Telecommunications is followed—is that the previous de facto immunity of senior individuals in the party to action in the courts may have been abandoned. Nevertheless, that remains a long way away from the party’s foregoing its constitutional primacy as an entity, and we see little likelihood that the fifth-generation leadership will move even marginally in that direction voluntarily, or, therefore, that the principle of ren zhi—which amounts in practice to government for the people, rather than by the people—will be abandoned in favour of that of fa zhi, the rule of law, which dominates Western political philosophy. What is more, contrary to the view of some of China’s critics in the West, it is by no means clear that ordinary Chinese, steeped for generations in the philosophy of Confucius, are anxious to see China move definitively away from the principle of ren zhi for all the fact that many—probably the majority—do look for government that is more transparent and accountable. However, quite how the latter can ultimately be reconciled with the former—if at all—is unclear.

**Working from the Bottom Up**

In the absence of a wholesale top-down approach to legal—and, by direct implication, political—reform, it is all the more important that the fifth-generation leadership really pushes ahead with what, at the time of our 2002 study, we termed “micro-political” reform. In addition to the legal base, the key areas that we identified ten years ago—and that, in our view, remain just as key today—are as follows.

**Red tape:** In Beijing itself and in the more go-ahead regions, the quality of China’s bureaucrats has improved enormously in the past ten years. And as occurred when the fourth generation took over, the transition to the even more technocratic fifth generation will see further improvements as the last of the old-style bureaucrats are weeded out of key positions in favour of—usually Western-educated and often now

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27 For an early example of how Chinese legal climate has improved in one important respect since our 2002 study, i.e., property rights, see “Landlords of the World, Unite!”, The Economist, 23 March 2002, p69.
Western-trained—technocrats. But this pattern is far from universal, and many of the poorer regions, including those that are now attracting some foreign investment as the interior opens up, are still ill served by their bureaucrats.

Institutional rivalry underlines the importance of personal networks

Furthermore, inter-institutional rivalry—be it inter-ministerial at the centre or between the centre and the regions—remains a significant handicap to coordination and cross-cutting decision-making. Where these are overcome, it tends still to be primarily thanks to xitong, or personal networks, within the bureaucracy, which stretch from the very top of government, through all levels of the bureaucracy and throughout the regions to the lowest levels of the administration, i.e., the danwei, or work unit. Furthermore, as the domestic private sector has expanded, the xitong increasingly overlap with individuals’ broader personal networks, or guanxi. And it remains the case that both xitong and guanxi are at their most potent where their links are within the party.

Much decision-making remains untransparent, and press freedom is limited

In consequence, transparency of decision-making—or, rather, the lack of it—remains a problem, as does the still-frequent absence of real public debate, which is compounded by the still-significant restrictions on press freedom despite some easing in recent years (tempered by self-policing in the—almost certainly justified—belief among journalists that overstepping the mark would result in a swift backlash from the party).

Civil society pressure is helping to drive regulatory reform

The regulatory framework: intimately linked to both the quality of the bureaucracy and the legal framework is the quality of China’s regulation and the mechanisms for regulatory enforcement. Again, there have been improvements. From the business perspective, one of a number of important areas in which China has really got up to speed is financial

28 A classic example of the Chinese authorities’ attitude towards press freedom is HIV/AIDS. Not only privately, but even in public seminars, Chinese ministers and senior officials are remarkably frank about the scale of the problem. They openly accept WHO estimates that the number of HIV/AIDS sufferers has risen from around ten million in 2000 to more than 30 million today and that more than seven million have died from HIV-related causes in the interim. (This latter figure is arguably still modest compared with the 1.9 million Chinese estimated to have died from air and water pollution-related causes last year alone; but pollution-related deaths appear to be in decline, whereas HIV-related deaths are on the increase). Yet when three Chinese newspapers reported the WHO figures last year, two were temporarily closed down and the editor of the third was fired. Furthermore, although China has eased its restrictions on the advertising of condoms, it continues to insist that this revolve primarily around its one-child-per-family policy, with minimal reference to STDs generally and none whatsoever specifically to HIV/AIDS.

What makes the value of these restrictions all the more questionable is the fact that information of this sort is widely known thanks to a combination of personal networks—significantly enhanced by the increase in individual mobility over the past 20 years and vastly improved telecommunications and internet access—and increased access to the international media. The result is an ever more stark contrast between the limited room for manoeuvre available to the domestic press and the much more extensive freedom of speech enjoyed by individual Chinese, for whom the line in the sand has long been that more or less anything goes except criticism of the party per se. That said, individuals, especially those who seek to organise dissent, do still risk falling foul of the authorities, as the treatment of leading dissidents periodically underlines.
regulation, but an equally key one in which it has not—at least in terms of enforcement—is intellectual property rights.

More broadly, not least in response to increasingly active civil society groups (see below) and in part linked to the dramatic clean-up in the capital that was associated with the 2008 Olympics, many environmental standards have improved markedly. Perhaps the most dramatic improvements have been in air quality, thanks in part to a lessening dependence on coal-fired power stations and broad use of cleaner technology, as well as increased energy efficiency, which has offset in part the increased energy demand associated with economic growth. But there are still major blots on the environmental landscape; for example, fresh water where illegal extraction and the dumping of untreated industrial pollutants remain significant threats to the quality (and, in the north of the country, quantity) of supply and to human health in a number of regions.

Together with concerns about labour standards, including China’s continuing resistance to adopting international covenants on freedom of association, environmental issues remain high on the list of (non-Chinese) NGO criticisms against Western firms investing in China. These are (inevitably) linked by the NGO community to broader human rights issues, including China’s one-child-per-family law (which is now being enforced with increasing stringency in rural areas) and the continued suppression by China of the activities of the Falun Gong despite significant relaxation of religious freedom over the past decade. And (equally

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29 A significant proportion of these gains could have been lost had private car ownership and use in China expanded at the rate many feared at the turn of the century. Astonishingly, given its doubling of GDP, the number of motor vehicles in China increased by as little as one-half between 2000 and 2010, to just under seven million (where car ownership per capita on a par with the U.S. would mean 600 million vehicles—more than all the cars currently on the planet). Furthermore, thanks to a policy mix of high fuel taxes and weighted tolls on intercity highways, as well as improving and subsidised public transport within and between urban areas, mileage per private vehicle per annum remains below half the OECD average. Nevertheless, there are some signs that middle-class urban Chinese, over 65% of whom consistently supported higher taxes to pay for higher environmental standards at the start of the century, are beginning to question the extent to which car owners (among whom they feature increasingly prominently) should be penalised fiscally. Furthermore, where China has recently sought to use regulation further to limit emissions from autos it has run into problems with U.S. exporters, an issue that is the subject of an ongoing WTO panel.

30 Long-standing concerns that water per capita, agricultural land, and range lands all remain below the global average are still being exacerbated by desertification, which continues to threaten a quarter of China’s land area despite significant—and regulation-underpinned—improvements in land management practices.

31 Even though Pan Yue, who will almost certainly retain his seat on the politburo in 2013, was one of the earliest public advocates of relaxing some of the restraints on “recognised” religions (his first article to this effect appeared in the Chinese press as long ago as 2001), it remains to be seen how much farther the Chinese authorities will be prepared to go in this regard, especially given the resurgence of Islamic separatism in the western Xinjiang province following the (popular) overthrow of the autocratic (and, essentially, ex-communist) regime in Uzbekistan in 2009 by Saudi-backed fundamentalists.
The fourth generation has failed to get a grip on corruption inevitably) to the (entirely non-regulatory) question of Tibet/Xizang, on which Beijing is unlikely to show any flexibility whatsoever.

**Corruption:** if the failure of the fourth generation to get a real grip on the long-standing problem of corruption in China is disappointing, it is also far from surprising. This despite the risk that the abuse of power for personal gain by officials and, in the case of high officials in particular, their children (these so-called “princelings”) pose in terms of disenchantment with the regime and, therefore, the CCP—not to mention the economic consequences, not least tax evasion. Abuses continue to range from mega-scale financial fraud to low-level demands for bribes by local officials for day-to-day services. The grand scale of corruption is underscored by series of scandals arising from contracts related to the 2008 Olympics, which, most commentators agree, is just the tip of the iceberg. The US$30 billion of Olympic-related government bond issuance is a drop in the ocean compared with the government’s huge liabilities relating to the pension system and bank recapitalization—but it is significant in that a large share of the issuance was to non-Chinese investors. This could soon become problematic given China’s international payment history. The government purportedly still owes US$89 billion for debt issued to U.S. entities during 1911-1942.

Successive anti-corruption drives have failed to get to the core of the problem—in significant part because, at least until the Hainan Telecommunications affair, even the most junior party members have seldom been exposed to due process in the courts. And where high-profile figures have been brought to justice, cynics continue to judge that—as with Hainan—this might not be entirely independent of political rivalry.

That said, some encouragement can be derived from the fact that a task force chaired by Pan Yue has for the past two years been studying counter-corruption measures in other economies and, in particular, in the Hong Kong SAR. And there is a growing sense, not least based on the Hainan precedent, that exposing party members to the full force of law can be accommodated without abandoning the principle of ren zhi. But even putting to one side the question of vested interest, genuine (if, in our judgement, misguided) disagreement persists within party ranks over whether public exposure of party officials would do more harm than good to the CCP’s image. It, therefore, remains to be seen whether the fifth-generation leadership will quickly be prepared to take the—perhaps deceptively—simple step of setting up a truly independent anti-corruption body with real teeth along the lines that have proved so successful in Hong Kong. What is certain is that in the absence of such a body, endemic and—for the CCP—highly corrosive corruption will never be eradicated.
Bridging the Gap

A 6 Micro-political reform will inevitably have implications for macro-politics

As 6 Arising from these micro-level political issues, we judge that there are four inter-related generic links into “macro-politics” that go to the heart of the challenges faced by the fifth generation, as follows.

Centralisation versus devolution: the core principle of government in China—at least, as seen from Beijing—remains centralisation of power. However, even putting to one side the difficulties facing Beijing, both historically and currently, in consistently enforcing its will throughout China, in practice, the situation is much more complex.

The past decade has seen a significant increase in the “labouratory testing” of devolved power to some of China’s regions, in particular those at the cutting edge of economic reform. Viewed from outside China, the biggest success story has been Shanghai, where increasingly devolved authority has permitted the development of a significantly more business-friendly legal and regulatory environment than remains the norm in China (albeit one that is still subject to the overarching principle of ren zhi). 32 But within China, feelings are mixed, thanks most notably to historic concerns over the consolidation of China within its external frontiers. 33 This has manifested itself most plainly in the fact that although Guangdong has been allowed to go some way down the track that Shanghai is taking, deep-rooted concerns about a possible north/south split underpin the tighter limits within which the regional authorities there are obliged by Beijing to operate. 34

Paradoxically, Beijing remains unable to impose its will uniformly throughout the country, even in matters rooted in law/regulation—which no doubt continues to contribute to the capital’s schizophrenic attitude to devolution. Perhaps the highest-profile example of

32 The speed at which Shanghai has been allowed to move forward is surprising, even though strengthening the legal base was long viewed as a necessary step by those who like to see the Shanghai/Hong Kong relationship as one of pure rivalry (a perspective that we do not share). See, for example, “Special Report: Hong Kong and Shanghai—Rivals More Than Ever”, The Economist, 30 March 2002, pp19-21.

33 For a resume of factors underpinning Beijing’s obsession with consolidation of its power within China’s historical (i.e., including Taiwan) borders, see chapter 1 of China: Gigantic Possibilities, Present Realities.

34 Beijing’s schizophrenic attitude to devolution has held back the development of Shenzhen relative to Shanghai (although the former has grown significantly over the past decade thanks to its importance as an entrepôt for southern China). However, it has (inadvertently?) helped to preserve the Hong Kong SAR’s status as a regional hub for services, in particular, even as its entrepôt role has gone into relative decline in the Pearl River region. This has helped Hong Kong to confound the pessimism that prevailed ten years ago (including in the HKSAR itself) by making the necessary adjustments to accommodate China’s emergence onto the global economic stage. The importance to Beijing of the HKSAR’s continued economic well being is not to be underestimated—not least because of the negative signal that Hong Kong’s failure would send to Taiwan.
Beijing's failure, at least internationally, is the continuing struggle in China over the protection of IPRs. For the fact remains that, despite repeated tightening of national law since 2001 (when the then 15-year old patent law was first upgraded) and half a dozen WTO panel rulings against China in the past five years, Beijing has failed to get a grip on non-cooperative regional authorities. Typical is the city of Yiwa, which, for more than 20 years now, has managed to protect its status as the wholesale centre for a nationwide counterfeiting industry, handling an estimated 2,000 tons of counterfeit goods per day.

On the other hand, we do see merit in Beijing's policy of “laboratory testing” new laws and regulations, as well as approaches to governance, in a limited number of regions before effecting change nationally. Although the consequent inconsistencies can be confusing for investors, by and large this has led to better-quality—and more business-friendly—national law and local government over time.

But the bottom line is that the fourth generation has really failed to evolve a policy on devolution of power to the regions, resulting all too often in muddle and mismanagement. The incoming leadership is well aware of this, but we see little likelihood of real progress in the short- to medium-term towards a clear—and constitutionally enshrined—policy on the division of power between the centre and the regions as the already over-rehearsed arguments for and against greater devolution continue to rage in Beijing. That said, we judge that the incremental drift towards greater devolved authority is set to continue, albeit in a somewhat ad hoc and geographically inconsistent manner.

Civil society pressures: when the British politician Peter Mandelson (now president of the European Council) visited Beijing in late 2001, he was asked by his Chinese hosts how they should go about “creating more civil society”. Mr Mandelson retorted (rightly) that governments did not “create” civil society; rather, their task was to create an environment in which civil society could thrive.

35 Although the full extent of the problem is relatively clear, what is less so is the extent to which this is a failure of will on Beijing's part. Corrupt senior figures in the capital are benefiting from widespread counterfeiting and still hold considerable sway in the face of increasing pressure for a real crackdown from legitimate foreign and domestic businesses alike. Furthermore, given the scale of counterfeiting and the number of jobs involved, a full-scale crackdown would undoubtedly have a significant negative socio-economic impact, which may be staying the hand of those in Beijing who favour firm action in principle.

36 Keep in mind, however, that the task force set up in 2009 to look at relevant models outside China (notably the EU, Germany, Canada, and Australia) is still in existence, and there are persistent suggestions that an early task confronting the fifth generation will be to consider a long-delayed report from it.
It is clear that China's leaders took this advice very much to heart. But they have also been characteristically cautious in terms of defining the parameters within which they have allowed civil society pressure groups to evolve. On the one hand, the past decade has seen a significant easing in terms of allowing homegrown non-government organisations (NGOs) to establish themselves in China (where previously operating without prior official authorisation was, to say the least, hazardous). As a result, the number of nationally registered NGOs has escalated around 20-fold since 2001 (from a base of about 100 at that time and literally none as recently as 1993), with many more operating at the regional and local level. On the other hand, spheres of operation remain limited, with more than 90% of both national and local NGOs focusing on the environment, counter-corruption, or consumer protection and none addressing political rights-related issues other than very obliquely.

That said, since the turn of the century, the rise of NGOs has significantly strengthened the voice of civil society throughout China and, in so doing, has enhanced the political power of ordinary Chinese, albeit in ways that are usually consistent with the policy objectives of the authorities in Beijing.37

Connecting with the people: from the perspective of the CCP, allowing the role of NGOs to expand as a voice of civil society has served another useful purpose in that it has acted as a safety valve where popular pressure for greater constitutionally enshrined political rights might otherwise have built up more rapidly. But as even the more conservative party members appreciate, NGOs are ultimately no substitute for real and universal representation.

But NGOs are no substitute for real and universal representation

Early experiments with elections were not encouraging

It was early recognition of the authorities' need to connect better with the ordinary people that lay behind the experiment of introducing limited democratic elections in rural areas in the late 1980s. However, as even the party's powerful Organisation's Department accepted, throughout the 1990s, these experiments were not a great success, as all too often they led to tensions between the elected leader and the local party secretary, with the latter

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37 The one major exception to this rule has been increasing civil resistance to major engineering projects, the roots of which can be traced back to the swell of protest that arose from the construction of the Three Gorges Dam—see China: Gigantic Possibilities, Present Realities, p. 28. That project marked, in our view, a watershed in the evolution of civil society in China, which first manifested itself in the authorities' subsequent decision to involve representatives of the NGO community in mega-projects more or less from the moment of their inception (which was initiated in practice with the co-option of the head of China's leading environmental NGO, Friends of Nature, onto the Beijing Olympic Committee in 2001). Opinions differ about the extent to which this has ultimately had an impact on whether projects have gone ahead or not. But experts do accept that the design of major engineering works is now significantly influenced by environmental impact assessments at the outset and that civil society pressures are a key factor underpinning that shift.
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July 20-24, 2002
Aspen, Colorado

almost invariably winning out. The immediate consequence of this was that the fourth
generation inherited an experiment that was, if anything, exacerbating popular discontent
in those areas in which it was being applied and a significant body of opinion within the
party that was against extending the experiment any further (and especially to urban areas)
because of this.

Inevitably, if regrettably, the fourth generation initially chose to mark time. Indeed, it was
not until the new—and more democratic, if still limited—system for the appointment/
election of Hong Kong’s Legislative Council (Legco), which was introduced in 2007, had
had time to bed down that there was any progress whatsoever. Nevertheless, in 2009, the
Shanghai Municipal Authority—which had been quietly exerting pressure on Beijing to
be allowed to move towards the HKSAR model for some time—was allowed to bring in
limited elections for less senior posts. A dozen other cities (but not Beijing) followed suit
in 2011/2012, when there was also some limited expansion of elections in rural areas.

Given the caution being exercised on the Mainland, it is, perhaps, all the more surprising
that Hong Kong moved as swiftly as it did to the election of its chief executive on the basis of
a commitment in the Basic Law to do no more than consider such elections as an “ultimate
aim” some time from 2007 onwards. That Hong Kong’s first election for chief executive in
March 2012 returned Regina Ip, who was appointed by Beijing to replace Tung Chee-hwa in
2007, will have boosted the confidence of the Mainland authorities vis-à-vis the HKSAR itself
and may encourage the fifth generation to expand experimentation with direct elections in
Mainland China more quickly than might otherwise have been expected.38

That said, we still expect the fifth-generation leaders to opt for no more than the most
cautious advances with direct elections on the Mainland. In particular, they are extremely
unlikely to favour elections of any sort above the micro-level in Beijing itself; and they will

But the example of the Hong Kong SAR
has encouraged a bolder approach
since 2007

But senior positions on the Mainland are
unlikely to be elected in the foreseeable future

38 Regina Ip almost certainly owed her appointment in 2007 primarily to her record as the HKSAR’s secretary for
security, where she succeeded in striking a delicate balance between various pressures from Beijing and broader
perceptions of Hong Kong’s best interests despite having to handle highly contentious issues such as the Falun
Gong, visas for Mainland dissidents, and right of abode in the HKSAR. But not least thanks to her longstanding
links with the business community, she was a popular choice and certainly one that inspired much more confi-
dence both in financial markets and among the ordinary citizens of Hong Kong than her predecessor had. Never-
theless, it is unlikely that anyone expected her to press for the election of the chief executive so quickly, let alone
to succeed in persuading Beijing to agree (for all Beijing’s desire to sustain international confidence in Hong Kong).
In the circumstances—and given Hong Kong’s sound economic performance since recovering from the 2008
slowdown—it is hardly surprising that she inflicted a heavy defeat on her sole opponent, the Democratic Party’s
Martin Lee, even though there is more than a hint that many votes were cast more with an eye more to keeping
Beijing happy than out of true conviction.
likely continue to resist elections for any of the top positions either nationally or regionally. Whether the limited representation, which such restrictions would permit, will satisfy the swelling political aspirations of ordinary Chinese is, however, a very open question.

**Taxation and representation:** public debt alone ensures that the tax burden on China’s urban middle classes, in particular, will become more onerous over the next ten years. This is likely only to increase the difficulties that the fifth generation will face in opting for a conservative approach to representation. The majority of Chinese probably have no knowledge of Charles Pratt, the 1st Earl Camden, let alone his 1766 speech on the taxation of (colonial) Americans by the British parliament. But the principle that he was espousing—i.e., no taxation without representation—is increasingly understood, and it is, in our view and with all due respect to Benjamin Franklin, almost as certain as both death and taxes that increasing taxation will further stimulate demands for increased representation. This is not a point that will be lost on China’s incoming leaders, faced as they are with the consequences of the loose—and, in recent years, overly loose—fiscal stance that has set public debt on an explosive upward trajectory.

**A Bridge Too Far?**

As these four “bridging” strands suggest, micro-political reform, while still both necessary and important, will no longer suffice. As with corruption, it is inherent in any meaningful attempt to address these strands that reform will begin to move higher up the political ladder and towards the centre of power itself.

This highlights what we judge to be an irreconcilable bottom line. Ultimately, it is not only the detail of the political status quo in China that is unsustainable in the 21st century. It is also and much more fundamentally the underpinning principles of China’s governance not only under the CCP since 1949 but arguably back to the start of the Zhou dynasty in 1030 BC. When a significant shift away from those principles occurs—as surely, one way or another, it must—it is by no means clear that it can be negotiated in a way that preserves the party’s grip on power (either in name or in deed). Yet even for China’s reform-minded fifth-generation leaders, that will likely prove a bridge too far.

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39 Speaking in the upper house of the British Parliament, Lord Camden said “Taxation and representation are inseparable. . . whatever is a man’s own, is absolutely his own; no man hath a right to take it from him without his consent either expressed by himself or representative.”

40 “In this world, nothing can be said to be certain, except death and taxes”: Benjamin Franklin (1706-90), 13 November 1789.
3. ASPIRING TO INTERNATIONAL LEADERSHIP

If China remains domestically cohesive, it is destined to become a major power and, as such, will have enhanced capacity to challenge the United States.  

*Henry Kissinger (2001)*

**A Force for Good?**

As we noted in our 2002 study, Dr. Kissinger was writing from the perspective of U.S. foreign policy, but it followed that China would also have an enhanced capacity to challenge the world as a whole. Since 2001, China has succeeded in remaining “domestically cohesive” and has, as we anticipated, emerged as an increasingly powerful player on the regional and global stage. And again as we anticipated, the “challenge” that China has posed to date has generally been as a force for good even as it has pursued an increasingly proactive foreign policy, which has (quite reasonably) been consistent with its domestic interests and regional leadership aspirations. In particular:

**The War Against Terrorism:** China has been supportive—or, at least, not obstructive—of the U.S.’s War Against Terrorism since the earliest days of the conflict in Afghanistan. It did not block various steps in the UN Security Council in the run-up to the Second Gulf War in January/February 2003. Despite continuing frictions with the U.S. over arms proliferation, it has suspended all sales to regimes accused by the U.S. of harbouring and/or supporting terrorists since Iran was lifted from Washington’s blacklist in 2005. And since al-Qa’ida’s devastating attack on Seattle in July 2007, China has been in the forefront of international efforts to ensure secure storage of all grades of nuclear waste and has significantly deepened its sharing of counter-terrorist intelligence with the U.S.

**The Korean Peninsula:** Behind-the-scenes pressure from Beijing played a significant part in the collapse of the regime of Kim Jong-il in the former DPRK in 2006, leading to Korean reunification in January 2007. Since then, China has poured billions of dollars into the economic reconstruction of the north.

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41 See China: Gigantic Possibilities, Present Realities, p124.

42 In a paper published by Rand in 2000, Michael Swaine and Ashley Tellis summed up China’s historic and current “grand strategy as comprising three interrelated strands, as follows:

- Keeping domestic order in the face of various social pressures;
- Defense against what China sees as persistent external threats to its sovereignty and territory; and,
- Gaining and retaining regional and geopolitical influence as a major, perhaps primary, state.

For further background, see China: Gigantic Possibilities, Present Realities, pp 85/86.
Peacekeeping: when the "Quartet" group turned its attention to the deepening Kashmir crisis in 2005, China was co-opted as a de facto fifth member. China has since led the UN-mandated peacekeeping force that polices the interim agreement signed by India and Pakistan later that year and will chair talks due to start in 2015 aimed at reaching a permanent solution. The PLA currently takes part in more than 20 UN peacekeeping/peace-monitoring operations worldwide, including on the South Lebanon border and in the international enclave around the Suez Canal.

Trade: inevitably, China has found itself in the dock in the WTO on just over a dozen occasions (mainly over IPRs)—and it has lost two panels it brought against other WTO members over their anti-dumping actions against Chinese exports. Furthermore, together with the EU, it remains locked in a long-running dispute against the U.S. and others over GM Os and food safety. And there have been persistent trade frictions with Japan. But at least in terms of resort to WTO dispute-settlement proceedings, China has been far more sinned against than sinner. Furthermore (and as previously noted), Beijing is widely credited with playing a key role in resuscitating the WTO after the near-total collapse of the Doha Round; and China is now seen—as together with Brazil, India, and South Africa—as an emerging economies' leader in the efforts to secure agreement to further liberalisations both in the WTO and in various regional fora.

Key Relations and Complex Issues
At the same time, even putting trade-related frictions to one side, aspects of Chinese foreign policy have continued to give rise to tensions. These have been particularly evident in China's two key bilateral relationships, i.e., those with the U.S. (by far and away the more important) and (related to Sino-U.S. relations) Japan. The complexity of these

43 The Quartet group—comprising the U.S., the EU, Russia and the UN—was originally set up in 2002 to try to broker a settlement in the Israel/Palestine conflict. Its early failures there did not discourage it from subsequent more successful attempts, with a range of other partners, at reconciliation and peace-building in a number of other conflicts. At the behest of more moderate Arab states and the PLO, China now participates as a de facto fifth member of the group in the latest attempts to resolve the long-running Middle East crisis.

44 One of the more significant reform achievements of the fourth generation has been the modernisation of the PLA. Large increases in defence-related expenditure have facilitated the purchase of, by non-U.S. standards, advanced equipment and allowed the PLA to improve pay and conditions to recruit and retain better-educated people. Manpower has been reduced by around 40% as evolving military doctrine has shifted the emphasis decisively from weight of numbers to greater professionalism and technological capacity and to strengthened air, naval, and integrated land/sea/air capabilities. The result is a truly modern defence force, albeit one whose capabilities are dwarfed by U.S. military power and will inevitably remain so long into the future. Unfortunately, increases in Japan's defence budget are driving PLA demands for new resources, which will be hard to resist even at a time when China's leaders might otherwise have been looking to stabilise defence expenditure.
Taiwan remains the biggest source of Sino-U.S. friction. The absence of a shared “vision” arising from Washington’s increased ambivalence over the (for Beijing) non-negotiable “One China” principle, serial and often deep-rooted misunderstandings, and mutual suspicion over each other’s intentions continue to dog Sino-U.S. relations across the board. This has been further fuelled by growing popular sentiment against the “One China” principle in Taiwan itself (which is manna to vociferous anti-Beijing lobbies on the left and the right in Washington, which have been quick to link it to the principle of self-determination). On the other hand, President Clinton welcomed the suspension of previously regular PLA exercises off Taiwan, which has been in force for the past two years.

Energy: the U.S. and Japan find themselves competing increasingly with China for access to energy resources in third countries and especially in the Gulf region. Even since the effective collapse of the theocracy in Tehran in 2004, the U.S. has remained suspicious of China’s close relationship with Iran. Similarly, China has consistently objected to the large number of U.S. troops stationed in Iraq since the Islamic revolution in Saudi Arabia in 2008, claiming that this is incompatible with Iraq’s status as a UN protectorate. More broadly, the increase in China’s demand for oil—driven in part by economic growth and in part by the environmentally based switch from coal to oil—makes it a principal driver in determining world oil prices.

Korea: the U.S. remains unhappy about having had to withdraw its forces from Korea in 2008 and (probably rightly) sees the hand of Korea’s now closest ally in the region, i.e., China, behind this. For their part, China and Korea (together with other countries in the

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45 A series of discussions in Beijing in April 2002 led us to consider that we had been a little too relaxed about China/Taiwan/U.S. tensions in our earlier study—see “Postcard from China”, Global Weekly Economic Monitor, 12 April 2002. However, we concluded—and continue to believe—that a peaceful solution to China/Taiwan remains probable, albeit still some years away.

46 The increase in China’s demand for oil over the past decade—driven in part by economic growth and in part by the environmentally based switch from coal to oil—has made it a principal driver in determining world oil prices, which has also caused periodic friction with other net oil importers.

47 On the other hand, China has remained silent over the continued presence of a 7,000-strong U.S./NATO garrison in Kyrgyzstan, just as the U.S. has turned a blind eye to what is widely believed to have been a massive Chinese cyber attack against critical infrastructure in Uzbekistan in 2010 in retaliation for the latter’s alleged support for Islamic separatists in Xinjiang.
region) are highly critical of the re-militarisation of Japan, which has been supported by the U.S. despite the overtly nationalistic stance of the Ishihara regime in Tokyo. The 2010 P'yongyang Mutual Defence Agreement between China and Korea was denounced by Tokyo and heavily criticised by Republicans in Washington, as are regular joint naval exercises in the East China Sea.

The U.S. remains openly critical of China's human rights record

**Human rights:** Beijing continues to smart over regular U.S. criticism of its human rights record (including in the context of Tibet) and is especially critical of what it sees as unwarranted and protectionist-driven linkage between labour standards and trade barriers against a range of Chinese manufactured goods that have been put in place under the Clinton administration since 2009.

Beijing and Washington are equally unhappy about one another's sales of arms

**Arms sales:** the U.S. periodically criticises China over arms sales, especially missile technology, to regimes which do not meet Washington's good governance criteria, even though Beijing has tightened up its controls in recent years and remains careful not to make sales to regimes that may be linked to terrorism. For its part, Beijing continues to react negatively to U.S. arms sales to Taiwan and to carp about missile defence, even though the U.S. administration has shown no inclination to deploy TMD in East Asia as yet.

China is determined to block a permanent seat on the UNSC for the Ishihara regime

**UN reform:** Beijing has not been alone in blocking long-running attempts to reform the UN Security Council. But its—unspoken but well-understood—absolute refusal to countenance permanent membership for Japan as long as Mr. Ishihara and/or his party is in power remains one of just a handful of deal-breakers.

More widely, China has been at pains to build better relations with partners both in the region and more widely.

Sino-Russian economic links continue to strengthen

**Russia:** Vladimir Putin and Hu Jintao, who enjoy good personal relations, have seen mutual advantage in developing closer economic ties, especially in China's helping to open up the energy and other mineral wealth of eastern Russia. The PLA has benefited considerably from the purchase of relatively advanced weapons systems from Russia, including submarines and fighter aircraft. The two also cooperate closely in the fight against Islamic terrorism, especially in Central Asia. China is also keen to dissuade Russia from further deepening its ties with NATO.

The past decade has seen a considerable improvement in Sino-Indian relations

**India:** Zhu Rongji's visit to India in January 2002 proved to be something of a watershed in Sino-Indian relations. Bilateral trade has increased from less than $3 billion in 2001 to
more than $70 billion in 2011, driven primarily by joint IT-related ventures by Chinese and Indian companies. The long-standing border dispute between the two countries was resolved in 2004, and China, traditionally an ally of Pakistan, was the obvious choice to head the peacekeeping force established in Kashmir in 2005. But New Delhi and Beijing continue to vie with one another in the emerging economies’ leadership stakes; and the former, which stands to gain permanent membership of the Security Council, resents the latter’s stance on UN reform.

**European Union:** trade, worth more than $350 billion in 2011, remains at the centre of Sino-EU relations. But cooperation on a range of international issues has become increasingly important since Peter Mandelson, who enjoys close ties with Hu Jintao, took over the presidency of the European Council in 2011. The joint EU/China space programme is aiming to send the first manned mission to Mars by 2020.

**Iran/Indonesia:** China’s closest partners in, respectively, the Middle East and South-East Asia; both relationships are driven primarily by China’s quest for secure supplies of energy.

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48 A direct comparison with trade levels in 2001—worth $77 billion—could be misleading inasmuch as the EU comprised just 15 members at that time as against 29 today (with Turkey likely to join by 2015). But 80% of China’s trade last year (worth, in total, $230 billion at 2001 prices) was with the 15 countries that were EU members in 2001, reflecting the relatively small size of the economies of the majority of the additional 14 members. That said, even that figure must be treated with caution since it is not always easy to establish the final destination of goods once they have entered the single market.

49 For background on China’s space programme, see “Taikonauts are go”, The Economist, 13 April 2002, pp 89-90; and “One Giant Leap for China?”, The Independent Review, 6 May 2002, pp 3-4.
4. CONCLUSIONS: NO EASY ROAD

Who dares claim that he is 100 per cent sure of success and that he is taking no risks? No one can be 100 per cent sure at the outset that what he is doing is correct.

Deng Xiaoping (1992)

In January 2002, we concluded that we were “cautiously optimistic” about China’s prospects over the following ten years. But we conceded that the value judgements we had to make in reaching that conclusion were such that we could not be sure that the fourth-generation leaders would succeed in keeping China on its then-clear path of economic reform combined with the defence of the political status quo. In the event, our cautious optimism has turned out to be justified in that China in 2012 broadly matches our expectations of a decade ago.

Looking ahead from here, for all the fact that there are pressing economic problems that need to be addressed urgently (notably, public debt and income inequality), we are encouraged by the generally impressive record of economic management that China’s leaders have demonstrated over the past 17 years. Furthermore, we note that the next generation of leaders shows all the signs of being even more competent in the art of governance than its predecessor and even more reform-minded.

On the other hand, there is no doubt that the new political challenges with which the fifth generation will have to grapple are considerably more demanding than the economic ones that China’s present leaders have overcome. The political risks—especially in terms of internal stability, but also in the form of the “external” threat posed by shifting popular sentiment in Taiwan—have already grown and look set to continue to do so. Inevitably, China’s economic performance will contribute to the containment or otherwise of these risks.

Signposts and Setbacks

As we did in 2002, we have identified eight key challenges for China’s leaders (several of which carry forward from 2002). And we have again highlighted (in italics) a number of indicators, which we will be monitoring in order to see if there is any evidence of the momentum of reform flagging and/or politico-economic risk increasing. The main difference between our 2002 and 2012 lists is that whereas the former comprised five essentially economic challenges and three primarily political ones, in the latter, the reverse applies, underlining the shift in the balance of risks in the interim. As in the decade
just gone, failure to overcome the economic challenges would increase the chances of internal political dissent; and failure to overcome the political challenges would certainly have adverse economic consequences.

Reducing the public debt-to-GDP ratio: At 100% of GDP, public debt is at the “ugly” scenario we presented in 2002 and, despite improvements in tax collection, absorbs around 24% of government revenues. Although the rate of debt increase has slowed since 2009, especially with economic growth per annum set to average a comparatively modest 5.5% over the next decade, additional taxes will have to be levied if debt is to be reduced to sustainable levels.

Failure to tighten fiscal policy by reducing present expenditures (e.g., remaining subsidies to agriculture), avoiding new expenditures (e.g., further large real increases in the military and space budgets), and deferring unpopular tax increases. Failure to crack down on tax evasion among top earners in particular.

Overcoming regional disparities: Although the fourth generation has made some progress redressing regional imbalances, a further 80 million jobs are set to be shed in the agricultural sector by 2020.

Slowdown in investment in the central and western regions. Slowing progress in rural industrialisation and agricultural reforms. Rural-urban income disparity continues to widen and urban unemployment rate increases further. Social unrest becomes more prevalent.

Financial sector reform: Although there has been considerable progress by the fourth generation, with capital market liberalisation still on hold and AMC-held NPLs still amounting to 20% of total loans, the next steps are overdue.

Government fails to move swiftly on capital account liberalisation, to float the RMB, and to complete opening up the stock market. AMCs slow to dispose of bad assets. Banks backtracking in implementing sound credit assessment policies.

Cracking down on corruption: Since 1992, the economic cost of corruption has been considerable, if unquantifiable, both in direct terms and indirectly as foreign investors, in particular, have been discouraged. Some estimates put the size of the underground economy at half the size of the official economy. Added to that is a political cost in terms of disenchantment among ordinary Chinese.
<table>
<thead>
<tr>
<th>Failure to set up a truly independent counter-corruption body with real teeth. Failure to expose party members and officials, senior and junior, accused of corruption to the force of law.</th>
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<tbody>
<tr>
<td>Devolving more authority to the regions: clearer and more consistent rules governing the levels at which policy decisions can and should be made and implemented would increase both transparency and accountability, as well as improve governance generally.</td>
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<tr>
<td>Failure by the centre to accept the principle of devolving greater authority to the regions. Failure to crack down on regional and local authorities that knowingly backslide on the proper enforcement of national laws and regulations.</td>
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<tr>
<td>Meeting domestic political aspirations: the extent to which ordinary Chinese in general and the urban middle classes in particular will continue to be prepared to forego additional political rights in favour of greater economic well being is unclear (especially given the prospect of the tax burden increasing). But popular pressure for more representation, accountability, and transparency is certain to grow.</td>
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<tr>
<td>Failure to expand democratic elections, both geographically and to higher levels in the administration. Repression of civil society pressure groups. Closing media outlets critical of the government. Increased civil unrest in urban centres in particular.</td>
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<tr>
<td>Closer economic ties are not yet helping to bridge the political gap between China and Taiwan</td>
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<tr>
<td>Relations with Taiwan: despite a huge growth in economic ties over the past decade, the complete abandonment of restrictions on direct links in 2004 and the renewal of top level dialogue in 2006, popular sentiment in Taiwan (encouraged to an extent by U.S. ambivalence) is increasingly resistant to the “One China” principle.</td>
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<tr>
<td>Taipei authorities’ rhetoric shifts further from the “One China” principle. Pro-Taiwan lobby in Washington gains the ascendancy, threatening deployment of TMD in East Asia. Suspension of high level Beijing/Taipei dialogue. Resumption of regular PLA exercises off Taiwan.</td>
</tr>
<tr>
<td>China’s key relationships with the U.S. and Japan will be subject to tensions</td>
</tr>
<tr>
<td>International relations: China’s increased, and increasingly constructive, role on both the regional and the international stage has been broadly welcomed. But the key relationship with the U.S. remains one of ups and downs as regional rivalry deepens and with frictions persisting over Taiwan, trade, and arms sales in particular. Beijing/Tokyo tensions have increased markedly and are no longer restricted primarily to trade.</td>
</tr>
</tbody>
</table>
Obstructiveness in international fora. Ratcheting back of support for international peacekeeping efforts. Consistent failure to comply with WTO rulings. Sustained tensions with the U.S. and/or Japan.

Uncertainty Ahead
The scale of these challenges is such that we find it impossible to be as confident of China's prospects for the next decade as we were for the one now coming to a close. One sure thing is that to have a chance of successfully addressing those issues that arise from domestic political considerations, in particular, the fifth-generation leadership is going to have to be prepared to take some significant risks. And those risks will involve a significant degree of uncertainty over whether the actions taken are consistent with the outcome sought and, therefore, over the probability of “success”.

That said, China's fifth-generation leaders will, in our view, judge correctly that the greater risk to their overall objective, i.e., keeping the CCP in power, lies in not being prepared to take risks with political reform in particular. Or, perhaps more pertinently in practice, in continued over-caution in the pace of reform in the name of trying to “be 100 per cent sure at the outset that what [they are] doing is correct”. We therefore lean towards believing that the fifth generation will be prepared to set off down the track of political reform fairly quickly after it takes over the reins.

But there are two fundamental ways in which the challenges of the next ten years look more demanding than those of the past decade.

First, while some experimentation with political reform is possible (as the “laboratory testing” of democratic elections in a limited number of regions demonstrates), it is, in our view, much harder to pull back from a specific policy approach once it has been adopted than is the case with economic reform. Thus, once ordinary Chinese get a taste of additional political rights, it will be nigh on impossible for the authorities to claw them back should they wish to do so.

And early steps will lead to demands for more, making the task confronting China's leaders increasingly hard.

Second—and perhaps even more critically—for the fourth generation, putting to one side external shocks, the dangers inherent in the reform of China's economy were greatest in the early years of their watch. Thus, as the fourth generation grasped the reform nettle after a hesitant start, the task confronting it gradually eased. Unfortunately for the fifth generation leaders (and, in all probability their immediate successors, who will govern China for the bulk of the 2020s), we suspect that in the case of political reform, the
challenges may prove more difficult the further down the track they go as the aspirations of ordinary Chinese continue to grow. And ultimately, we judge that it will prove impossible to reconcile those aspirations with the maintenance of either the present de jure, or even a de facto, one-party state.

Whether the “crunch point” for the CCP will arrive during the fifth generation’s watch or not remains to be seen. If China’s leaders are prepared to address expeditiously outstanding items of economic reform while, at the same time, advancing political reform at a steady pace, we judge that it need not. Indeed, a major political crisis of some description — and/or the collapse of the present regime — is by no means inevitable. And even if that were to happen, the result would not necessarily be chaos. But at this stage, we find it impossible to put the chances of China’s continuing to enjoy a relatively smooth transition towards becoming a fully functioning democratic free market economy for the duration of the next decade at better than 50:50.
5. CHRONOLOGY: KEY EVENTS 2002-2012

2002

May
Hu Jintao and U.S. President Bush meet for the first time (in Washington). Resumption of Sino-U.S. military cooperation (suspended during the 2001 spy plane incident). No agreement on the “One China” principle.

September
U.S. troops withdraw from Afghanistan as Washington declares that mopping up Taliban/al-Qa’ida forces completed and announces the setting up of a “permanent” U.S. garrisons in Kyrgyzstan and Uzbekistan.

October
Hu Jintao is appointed Secretary General of the CCP at the 16th party congress. Jiang Zemin retains the chair of the Central Military Commission and secures the right of business leaders to be CCP members.

December
UN weapons inspectors expelled from Iraq as Saddam Hussein calls on Arabs to resist “U.S.-Zionist imperialism”. China supports a U.K.-sponsored UNSC resolution threatening military action against Iraq unless inspectors are allowed to return.

2003

January
The Second Gulf War results in the defeat of Iraq by combined U.S./U.K./Turkish forces and the overthrow of Saddam Hussein. In March, Iraq is declared a UN-protectorate, initially for a three-year period.

March
Hu Jintao is confirmed as China’s new president and Wen Jiabao is appointed premier. China’s stock market soars to a record high.

June
The U.S. and U.K. embassies in Manila are damaged by rocket attacks. 10,000 additional U.S. troops deploy to the Philippines as Washington announces direct U.S. military action against Abu Sayyaf.

September
Moody’s downgrades Japan’s sovereign credit rating to one notch below that of South Korea’s.

December
China’s inward FDI surges to a record US$65 billion. China eases capital account restrictions by introducing a Qualified Foreign Institutional Investor scheme.

50 A chronology of key events in China between 1030 BC and 2001 AD can be found at Annex A of China: Gigantic Possibilities, Present Realities
March 2004
China’s stockmarket crisis triggers major demonstrations in several cities, leading to the announcement in early April of a far-reaching stockmarket reform programme by Wen Jiabao and effectively reenergising structural reform across the board.

Pro-“One China” James Soong wins the presidential election in Taiwan as support for the KMT continues to disintegrate and the electorate reacts to the economy’s poor performance under Chen Shui-bien.

The U.S. closes its last military base in Saudi Arabia.

June
Beijing announces high-level talks with Taipei on removing all restrictions on cross-strait links.

Massive popular demonstrations in Egypt lead to the overthrow of the Mubarak regime. The U.S. suspends aid to Egypt pending elections and threatens intervention if Egypt mobilises against Israel.

July
The PBOC announces an immediate widening of the RMB trading band to ±3%. The RMB appreciates, propelled by strong capital inflows.

The WTO rules in China’s favour in its anti-dumping dispute with Japan. Beijing brings in retaliatory duties against Japanese autos and trucks.

September
Japan announces additional anti-dumping measures against Chinese exports.

November
Egypt’s new coalition government, comprising Islamic and secular parties, agrees to the demilitarisation of Sinai and international policing of the Suez Canal zone in return for a massive injection of foreign aid. The PLA contributes 500 troops to the UNMOSC force deployed in May China and India resolve their long-standing border dispute.

2005
January
George W Bush is inaugurated for a second term as president as the Republican Party retains control of the U.S. House of Representatives but fails to win back a majority in the Senate.

May
The Quartet, supported by China, set up talks to ease escalating tensions in Kashmir.

A WTO panel finds in Japan’s favour over anti-dumping measures brought in against a range of Chinese goods in September 2004.

June
Major student demonstrations in Tehran trigger a process, which leads to far-reaching constitutional changes later in the year ending the de facto theocracy in Iran. PetroChina signs two major extraction contracts with the new Iranian government in November.

July
China’s first manned space flight.

October
China takes command of a new UN peacekeeping team installed as part of the Quartet-brokered interim agreement between India and Pakistan on Kashmir.

December
The DPP wins an outright majority in the Taiwan’s Legislative Yuan. China’s FDI inflows soar: $90 billion.
2006

January
All restrictions on direct links between China and Taiwan are lifted subject to “normal” visa controls.

The Chinese government injects public funds equivalent to 25% of GDP to recapitalise the banking sector. China’s public debt now stands at 70% of GDP.

April
Following a particularly severe winter, the regime in North Korea collapses and Kim Jong-il goes into exile in China. Korean reunification talks begin in Beijing.

July
China and the European Space Agency announce a joint programme aimed at sending a manned mission to the Moon in 2011 and to Mars by 2020.

October
China introduces a national minimum pension and announces the deregulation of interest rates. New measures are also introduced to create a deeper corporate bond market.

December
China widens the RMB trading band to ±6%; the RMB appreciates to the top of the band.

China overtakes France to become the world’s fifth largest economy.

2007

January
Korean reunification.

March
The new Legco in Hong Kong comprises 40% democratically elected seats. Former Security Secretary Regina Ip succeeds Tung Chee-whoa as HKSAR chief executive.

June
The banking sector crisis in Japan forces the resignation of the LDP-led coalition government.

July
On U.S. Independence Day, a massive explosion in a ship-borne container spreads low-grade radioactive waste throughout Seattle, effectively crippling the entire city despite fewer than 100 fatalities. President Bush vows to re-intensify the worldwide effort against al-Qaeda.

August
Shintaro Ishihara’s New Nationalists win 40% of the seats in the Diet and form a coalition government with the Conservative and Komeito parties. Mr Ishihara announces a 20% increase in the defence budget and sets in train moves to lift all restrictions on Japanese military deployments “to counter international terrorism”.

October
At the 17th party congress, Hu Jintao is appointed chair of the Central Military Commission as Jiang Zemin goes into formal retirement.

November
China, hosting the WTO Ministerial, brokers the Shanghai Agreement on future trade liberalisation negotiations as the Doha Round is effectively abandoned.

December
The U.S. Congress votes to sell stealth technology to Japan.

The Bank of China lists on the domestic stock market.
2008

January

The al-Saud regime collapses overnight and a new Islamic republic is declared in Saudi Arabia. The new government threatens a complete embargo on all oil sales to the U.S. unless Israel withdraws to its pre-1967 borders within 12 months. Oil prices go through $50 pb. Washington announces that it is deploying two armoured divisions and air support to Iraq sine die “to protect the interim regime” there.

February

The authorities in Seoul formally ask the U.S. to withdraw its forces stationed in Korea, publicly stating that they are no longer required following the peaceful reunification of the peninsula. Privately, it is clear that the move arose in significant part from U.S. support for Japan’s re-militarisation.

March

Bo Xilai is appointed premier in place of Wen Jiabao. Pan Yue joins the politiburo and promptly announces an easing of religious freedoms while denouncing the Falun Gong in the strongest terms.

The DPP regains the Taiwanese presidency. Probably with the possible threat of an Olympic boycott by the U.S. in mind, Beijing commits to continuing dialogue with the new government.

September

Beijing hosts the 2008 Olympics. China finishes second only to the U.S. in the medal tally.

The “Quartet plus 1” (ie China) announces fresh peace moves in the Middle East (which remain in train).

December

China officially adopts a managed floating exchange rate system (the RMB appreciates to RMB=$7.2).

2009

January

The RMB moves to a managed float against a trade-weighted basket of currencies.

Hillary Clinton is sworn in as U.S. president. The Democrats retain control of the Senate but the Republicans still hold the majority in the House of Representatives.

February

Following a Turkmenistan/Saudi-backed coup in Tashkent, the new government declares an Islamic republic in Uzbekistan and withdraws military facilities made available to the U.S. by the Karimov regime.

June

China sets up a task force to look at federal models worldwide as, for the first time in an urban area, the Shanghai Municipal Authority holds democratic elections for a limited number of posts.

December

In the Taiwanese general election the DPP retains its majority in the legislature.
2010

March
The collapse of Hainan Telecommunications is followed by a wave of high-profile arrests on charges of corruption including three senior party officials, two of whom are sentenced to death in the subsequent (ground-breaking) court case. China sets up a task force to look at anti-corruption mechanisms worldwide.

April
China and Korea sign the Pyongyag Mutual Defence Agreement, as China announces that it is suspending all military exercises off Taiwan in favour of joint exercises with Korea in the East China Sea.

July
Shanghai hosts EXPO2010.

Beijing warns Tashkent over its alleged support for Islamic separatists in Xinjiang, heightening suspicions that it was a PLA cyber attack which knocked out the entire Uzbek electricity grid in June.

September
Completion of the joint China/EU Marco Polo permanent manned space station.

December
China overtakes the U.K. to become the world’s fourth largest economy.

2011

May
Democratic elections are expanded in China’s rural areas for the first time since 1990 but remain limited.

June
Twelve municipal authorities in China follow Shanghai by holding democratic elections for some posts.

The New Nationalist-led coalition in Japan is returned with an increased majority in the Diet.

October
First joint China/EU manned mission to the Moon.

2012

March
Incumbent Regina Ip defeats the Democratic Party’s Martin Lee in the HKSAR’s first democratic election for its chief executive. Elected Legco seats remain at 40%.

May
China’s public debt swells to 100% of GDP.
6. AUTHORS’ NOTE:
FORECASTING, FUTUROLOGY, “FACTS,” AND “FEEL”

This paper seeks to paint a picture of China and its prospects ten years hence, drawing on a synergy of two far-from-precise “sciences” — economic forecasting and its even more hazardous political equivalent, futurology. Even over a period far shorter than a decade, it is inevitable that at least some predictions made in the course of such an exercise will prove to be inaccurate. Hopefully, these will be relatively minor. But the unforeseen events of 11 September 2001 are a salutary reminder of how hazardous prediction can be for both economists and political analysts.

However, it was never our intention to reach for the impossible and present a picture correct in every detail. Rather, we ask the reader to focus primarily on the “broad canvas” for which we have extrapolated — both economically and politically — from our generally well-received 2002 study China: Gigantic Possibilities, Present Realities. That canvas represents, in the broad, our best “guestimate” of where China will be in 2012 and the challenges that its leaders will face in the following ten years or so. Inevitably, given China’s growing importance on the global stage, this has also involved a number of assumptions about the state of the world and the evolution of other major global and regional players.

We could have presented that canvas as a dry statement of the probable (as we judge it) bare “facts”. But to try to add some “feel” to the “facts”, we have opted for a narrative approach that incorporates a good deal of “colour”, much of it in the footnotes and the chronology to avoid unduly disrupting the “plot”, as well as footnoting a number of contemporary references, all of which are genuine. Furthermore, all the personalities mentioned in the paper are real people who could, in our view, quite conceivably occupy the roles we have given them in 2012. It is our hope that this will not only give the reader a greater sense of potentially key factors and personalities underpinning our broad canvas, but that it will also help stimulate and inform substantive debate without the discussants getting bogged down in inevitable differences of view over the detail. It was, after all, just as much our brief to be provocative as it was to be informative.

51 For those looking for more “colour” who wish to delve still further into the very large amount of literature available on China, there is a selected bibliography at Annex F (pp141-2) of China: Gigantic Possibilities, Present Realities.
Underpinning this is the thought that for policymakers—and those in a position to influence policy, including in the private sector—one of the purposes of any predictive exercise of this sort must surely be to inform thinking in order to maximise the probability of more desirable scenarios emerging downstream and minimise the risk of less desirable ones. Thus, the aim of the futurologist/forecaster is not only to prepare for probable future events and circumstances but also to make self-denying prophecies as well as self-fulfilling ones. Sometimes this involves thinking the unthinkable, so we have not sought to avoid unpalatable scenarios.

In all modesty, we therefore submit this paper to scrutiny and debate in the hope that, in some small way, it will help decision-makers ward off some of the less-desirable potential events and circumstances we have painted into our canvas and that the future will turn out to be brighter than we have anticipated in some respects.
CASE QUESTIONS

1) Will China pursue an increasingly proactive foreign policy? Will China continue to support the War against Terrorism? How would the reunification of Korea change the foreign policy dynamics in Asia? Will closer economic integration help bridge the political gap between China and Taiwan? Will regional rivalry and trade tensions grow between Beijing and Tokyo?

2) Will China succeed in making the transition from a command economy to a more open market-based one? Is it realistic to assume that China will double its 2000 GDP by 2010, overtaking the U.K. to become the world’s fourth largest economy? How important a role will hosting the 2008 Olympic Games play in shaping China’s future? Do foreign policymakers underestimate the growing importance of China to the vitality of the global economic system?

3) Although Japan comes close, no other country—let alone the world’s most populous nation—has been under so much pressure to reform economically in so short a period of time. There are bound to be some setbacks over the next decade. What are the biggest risks? A stock market crash? A series of rolling financial crises? Social instability? Reneging on WTO obligations? Failure to embrace global environmental reforms? An external shock, such as Taiwan or another border conflict with India?

4) Is the “Japan model” still relevant to China? What lessons can China learn from Japan’s postwar successes and from its more recent “lost decade”? China is suffering from severe structural economic problems, including a broken banking system, weak state-owned enterprises, a rapidly ageing population, inadequate social welfare and price deflation. China is embarking on expansionary fiscal policy to support the economy, while deposit interest rates are at an historical low of 2.0%. After taking into account all the government’s contingent liabilities, the IMF recently estimated that China’s public debt is already 75%-100% of GDP, compared with the government’s estimate of 23%. Is this fiscal trend sustainable without problems?

5) How big is China’s economy? Some argue that China’s official GDP growth is substantially overstated, while others claim that China’s U.S. $1 trillion economy, in PPP terms, is in fact closer to U.S.$4 trillion, making it already the world’s second largest. Does this imprecision matter for the global financial system?
6) China is blazing a clear path of economic reform, but with a rising urban middle class, when—if at all—will China’s leaders succumb to political reform? What types of political reform will ensue and what will the implications be for the current political system?

7) When will China’s capital account be liberalized fully? As a first step, will a Qualified Foreign Institutional Investor scheme be introduced, and if so, when? What should be the appropriate sequencing of reform in moving to capital account convertibility? When will China start moving toward a more liberal exchange rate regime? And under a more flexible regime, would the renminbi appreciate or depreciate? In the longer run, will the HK$ be re-pegged from the U.S. dollar to the renminbi?

8) Many forecasters see impressive FDI inflows to China, rising from US$47 billion in 2001 to US$65 billion or higher by the end of 2003. Is this realistic, or will China’s poor track record on issues like corruption, intellectual property rights, and a weak legal system cause foreign investors to soon shy away after the initial WTO-induced euphoria?

9) Will China succeed in broadening and deepening its capital markets? For example, will the growth of the middle class be accompanied by development of a vibrant mutual funds industry by 2012? How will the roles of Beijing, Hong Kong, and Shanghai evolve in financial affairs? Will one city emerge as the Chinese financial capital?

10) Given the above questions, how much access will China have to the global capital markets during 2002-2012? How much access to non-local will China need?

11) As non-local foreign investment in China expands, how should non-Chinese global debt asset managers approach the strategic promise of Chinese capital markets? Should they begin to search for strategic Chinese partners, set up wholly owned operations, or wait until the second half of the 2000-2010 decade, if not later?